RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958

PO Box 1759, La Jolla, California 92038

17 Letters Per Year - $250 Annually

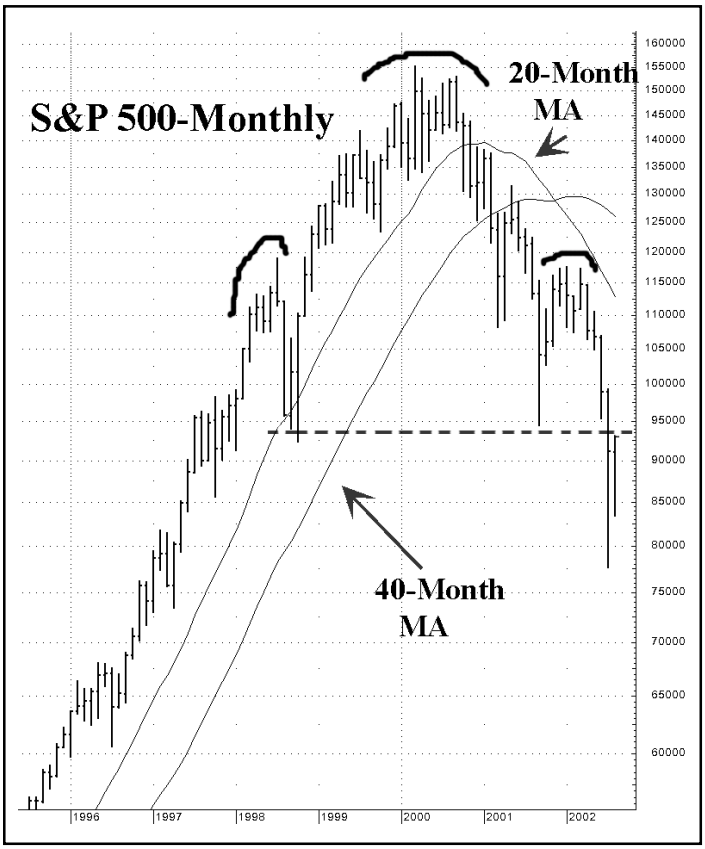
LETTER 1340

August 21, 2002

Aug. 2, DJIA 8313.13; PTI 5219; A-D Ratio -4.37
Aug. 9, DJIA 8745.18; PTI 5239; A-D Ratio -3.72
Aug. 16, DJIA 8777.99; PTI 5240; A-D Ratio -2.96
S&P Yield: 1.69% S&P p/e: 37.60
Gold 50-Day MA: 317

S&P 500 Composite — Let's start this Letter off with the very big picture. And here it is, the average that the pros follow, the S&P 500. I've charted the S&P on a monthly basis, and with it I show the long-trend 40-month moving average and the faster-moving 20-month moving average.

What we see here is the most massive top ever built in the history of the US stock market. It's a "head-and-shoulders" top, which is a way of saying it's a huge area of distribution. The horizontal dotted line is the "neckline" or line of support. The support comes in at around 945 for the S&P. This support was violated last month when the S&P smashed below the 945 level, dropping down to a July 24 intra-day low of 775. The July decline produced an oversold situation in the S&P. From the July 24 intra-day low, the S&P rallied to an August (so far) high of 942. That is where we are now.



My guess is that we'll now see a period of backing-and-filling, popping and flopping, all of which will give way to a renewed decline which will take the S&P to new lows below the July lows in a final decline which could produce an historic oversold bottom. That bottom could be lower than most people are thinking about. It will be low enough to finally turn the public bearish on the market.

Question — Russell, I take it that you're thinking that this decline is just one leg of the bear market, and it's a down-leg that has not been completed?

Answer – That's correct. When this down-leg finally hits bottom, which I think will occur before the end of this year, I believe we will then see a major upside correction that will take the market to a high next year in 2003. That corrective leg should serve to turn the crowd bullish, at least bullish near the highs. From the highs of next year, I expect the final or "C" down-leg to begin. This will be the "killer" leg, the most costly and most frightening leg of the bear market. I don't expect this final leg to end before 2005 or even 2006. This final leg will end with stocks selling at great values.

Question – What could occur to drive the final leg down to the point where stocks are at great values?

Answer – I can only offer my own guesses. It could be a dollar collapse, it could be a debt melt-down, it could be war, it could be a collapse in the bond market along with severe credit troubles, it could be general social and political turmoil, or most likely it could be a severe recession (depression) in the US or even throughout the world.

Note on the chart that the 20-month moving average crossed below the 40-month MA in November of 2001. I believe that this is a fateful and very bearish technical event. It shows us that the decline in the S&P is accelerating. My guess is that this bear market will go further on the downside than almost anyone is thinking about or considering. It's going to be the Big Daddy of all bear markets. I base this on the size of the top in the S&P and the many months of intense, really outrageous speculation that were going on near or at the top. My guess is that the despondency and bearishness at the final bottom of this bear market will be a mirror of the insanity and bullishness that occurred at the top during 1996 to 2000.

BIG PICTURE – The world is facing a phenomenon that has never occurred before. It's the phenomenon of **world over-production**. Today dozens of nations are producing products, advanced tech products, space age products, basic products, cars, refrigerators, clocks, clothes, items that they've never been able to produce before.

Today the whole world is in mild to advanced recession, and the way out for most of these nations is to export. So an international battle for exports is taking place. Every nation is trying to increase its exports and in so doing trying to keep their standard of living from sliding.

In this situation, the United States has been buyer to the world. Without the phenomenon of massive US buying, the world would now be a different place, with many nations in dire straits. The appetite of the US: from its ravenous consumers, to its massive defense establishment, to its huge housing industry, to its seemingly endless appetite for new cars, has been one of the chief wonders of the post World War II years.

All of this has been built on a giant structure of debt. Estimates of US debt are just that – estimates. Consumers have over $30 trillion of debt outstanding. The US government has over $6 trillion of debt outstanding. The states, counties and cities have countless trillions of debt outstanding. Nobody knows how much unaccounted-for debt is outstanding. The US has built the greatest debt structure in the history of the world.

This debt must be serviced; interest must be paid on these multi-trillions of dollars of debt. To service all this debt, the Federal Reserve has carried on a policy of steady expansion of the money supply, and this process alone is inflationary.

The theory is that the Fed can generate just the right amount of money so that the whole situation can be "handled" efficiently. There would be no sudden surge in wholesale prices or consumer prices. Prices would rise slowly over time, and in that way nobody would be bothered or alarmed by their slow and subtle rise.

Those who are older, such as your own Richard Russell, can remember the march of prices. I remember seeing new Fords advertised in New York during the mid-1930s at $450. I remember a loaf of bread at a dime. I remember triple-scoop ice cream cones being sold here in San Diego for a nickel. I remember just after World War II ended seeing new Buicks selling at $1800. I remember slowly paying off my GI life insurance. The policy was for $10,000. That was big money in the 1940s.

The Fed has pursued a policy of slow, steady, rising monetary and price inflation. The Fed was able to follow that policy because the Fed could generate a rise in bank credit and the money supply. As the years went by, the Fed believed increasingly that it was its job to oversee the growth of the economy. The Fed would lean against the wind, pressing down on the economy when it overheated and stimulating the economy when it began to slump. Furthermore, with the advent of the "Full Employment Act" the Fed felt that it was its duty to prevent business slumps and recessions. In the idealized world that the Fed envisioned, there would be no more recessions, no more hard times, just brilliant manipulation. That was the theory.

But the Fed did not plan on world over-production. The Fed did not envision a low wage China which could manufacture literally all the items and objects that the entire world needed. The Fed never planned on massive fields of grain that were growing in many other nations. Here in the year 2002 the entire world has become expert at producing almost everything.

Even high-tech is now coming out of many countries from India to Germany, from Ireland to China. And much of it, particularly out of Asia, can be produced at vastly lower prices than it can be produced in the US.

So in the face of today's world deflation, what was the Fed to do? The Fed's answer to every problem was to pump up the money supply. The S&L mess — pump up the money supply. A nation in trouble — give them a loan and pump up the money supply. Corporate scandal, a threat to the banks, a huge bankruptcy – pump up the money supply. Do what ever you have to — but above all, don't allow the natural forces of correction to take over. Fight every emergency and potential emergency with the money-narcotic, a surging money supply.

But suddenly here in the year 2002 with the Fed gunning the money supply for all it's worth, the economy remains in trouble. With US manufacturing slumping, with American consumers loaded with every possible device, car, home, and what-have-you – where is all this liquidity going? With the stock market caught in the grip of a primary bear market, the liquidity has been going into housing.

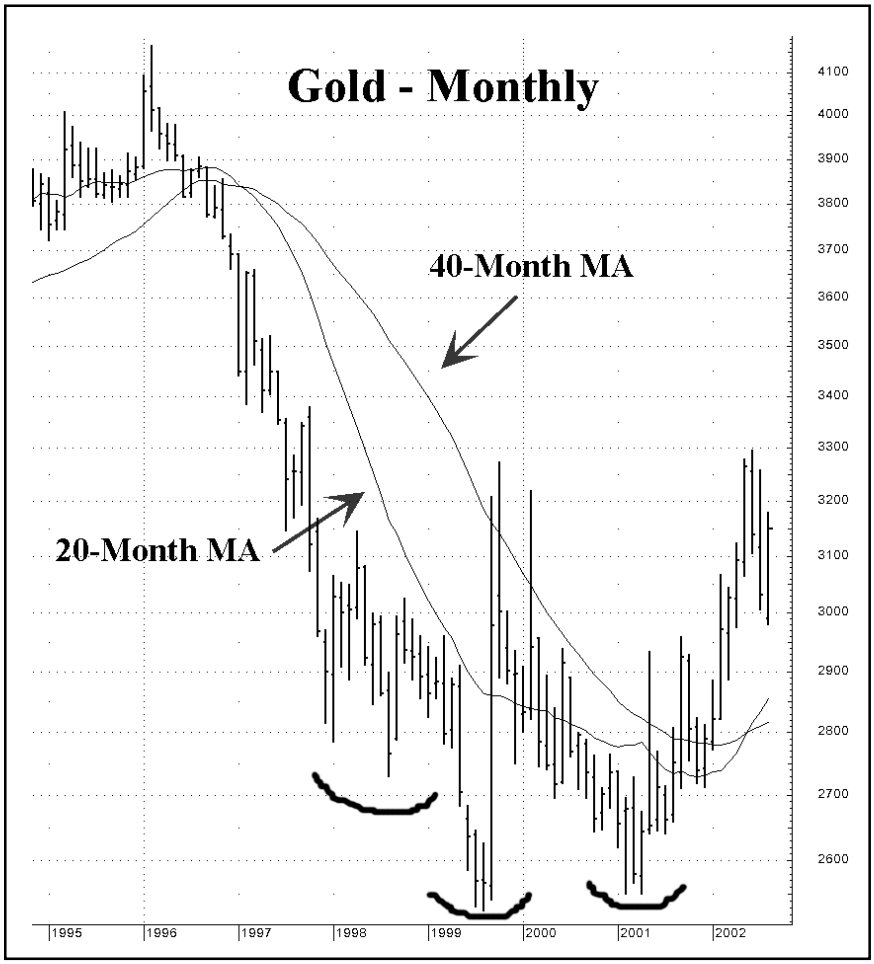
The housing bubble has replaced the stock market bubble. "You want savings, buy a house. Forget your losses in the stock market, forget the stock market, you've got to own your own home, because a home is your single best and safest investment."

Go through my neighborhood in La Jolla, California. Every house is worth multiples of a million dollars. Are all these hundreds of home-owners – all worth millions? It's amazing, all these people in La Jolla millionaires. And how did they become millionaires? Why they bought homes a year or a few years or ten years ago, and suddenly they are millionaires. Amazing. Incredible. Who do we thank? Why thank Mr. Greenspan and the Fed. Is this a great nation or what!

But didn't we say the same thing about the stock market a few years ago? Weren't stock market millionaires a dime a dozen in 2000? And now look what's happened. Well, what's happened is that the bear market reduced the rolls of the millionaires. The *New Yorker* magazine included a cartoon a few months ago. It showed a fellow reading a book entitled, "Ten Ways to Break Even." Today everybody "gets" that joke. Nobody has to explain that cartoon to anybody else.

I've been warning that this nation is now in the position where figuratively, it must INFLATE or DIE. The Fed must get this nation on the re-inflation path again. If we can't re-inflate, then the mountains of debt are going to eat us alive. Rising inflation makes it easier to service debt. Debt becomes worth less as the dollar becomes worth less. Inflation is a God-send to debtors and a thief to creditors.

But in this country there are a hell of a lot more debtors than creditors, and it's the debtors that the Fed serves. They serve the debtors with bail-outs when the big-time debtors can't pay their debts, and they serve all the debtors by making their dollar-denominated debts worth less and less through the process of inflation.



How do we protect ourselves against the Fed? While the bull market was on, we could protect ourselves by buying stocks. And half of all of American families did just that. They put their money into mutual funds and individual stocks and tech stocks and Internet stocks and 401(k) plans. But oops, the bear market arrived. The stock market bubble burst.

But wait, one's home has become the new stock market. Month after month the price of homes pushes higher. Home prices rose, they continued higher, they surged. Your home is your fortune, your savior. Borrow against it, take out some money, take a vacation, and buy a new car. "Why worry, brother, the realtors are calling, wanting to know whether you're willing to sell your house."

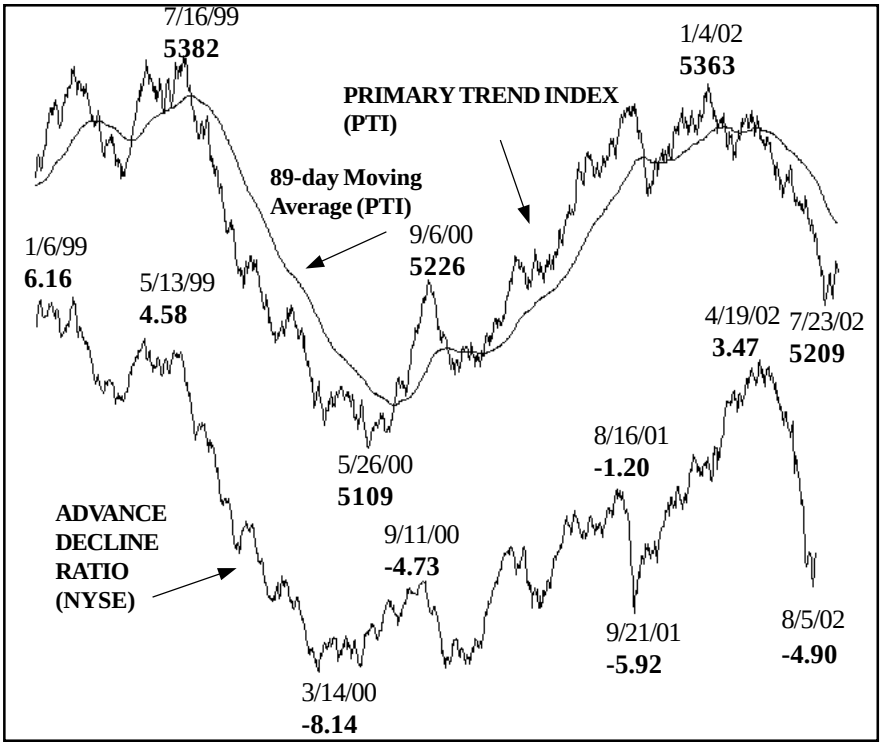
And here's the Fed, pumping up M-3 at the rate of $20 to $30 billion a week. "What, that's not enough? Then hell's bells, lets make it $40 billion a week – or more." Anything to keep this economy from sinking under an avalanche of debt. Anything to keep the stock market from sinking any further. Anything to keep the blessed home prices climbing. Anything to keep US consumers consuming. There's too much debt out there, there are too many mortgages out there – to allow this economy to contract. Inflate, inflate, and inflate.

So again, how do we protect ourselves against the predations of the Fed? I believe we do it with the only real money that is not someone else's liability. I believe we do it with the only wealth-item that is intrinsic, that has no debt against it. I'm obviously talking about **gold**.

I'm including a monthly chart of gold along with two long-term moving averages. One average is very long-term; it's a 40-month (over three years) moving average of gold. The other average is a 20-month (just under two years) moving average of gold. It's the juxtaposition of these two averages that defines a long-term trend. And a 20-month MA and a 40-month MA just don't move very fast. It takes a lot of trending to move these two averages. You can see it all on this chart.

The 20-month MA crossed above the 40-month in May of 2002. Both moving averages are now rising. The 20-month MA has been above the 40-month MA for three months running.

The last downside crossing of these two moving averages occurred on January 1997, and that negative crossing lasted for five years. I wouldn't be surprised if the May 2002 positive crossing held in force for 3 to 5 years. It looks to me as though gold is just in the very early process of moving out of its base.



LISTENING TO THE MUSIC — Last week Michael Phelps (he just turned 17) broke the US record in the 200-meter individual medley at the summer national championships at the Hall of Fame pool.

How does this 6-foot 3 1/2 inch teenager do it? For one thing, he's developed a habit of listening to music on a headphone-set until seconds before a race. Said Phelps, "When I put the headphones down, it's time to face it. There's no time to get psyched out or think about too much."

Investors could learn something from young Phelps. The only problem is that in investing the Phelps technique works in reverse. The music you hear in this business comes from the *Wall Street Journal* and *Barron's* and the *New York Times* and CNBC and CNN-FN and Bloomberg. It's the music that fills every day with data, rumors, forecasts, expectations, old news, newer news and just endless yada yada. Whereas the music that Phelps listens to prior to a race is soothing, the music investors listen to drives them nuts and tends to obscure the reality part of investing.

Often, when I hear reporters talking on CNBC at 4 in the morning, I say to myself, "C'mon, please, stop all the talking and just give me the damn quotes. Where's the S&P, what's gold selling for, where are the bonds, where's the dollar?" Give me prices, give me the charts, give me quotes and you can keep all the "hot news" and analysis and forecasts.

Of course, there's another thing about Phelps and his swimming races. When he finishes a race, he knows whether he's won or not, and he knows exactly what his time was. In the business of investing you're never finished, the game is never over, and you can never be sure whether you're a winner. Or if you are a winner, you can ask, "A winner, yeah, but for how long?" There are actually a number of ways of being a winner in this business, although these methods are simpler said than done. Nevertheless, many people actually come away from Wall Street with more money than when they started.

For the average investor, I recommend either of two methods. The first method I call the "royal road to riches." That's another name for compounding. I describe this method in the piece entitled "Rich Man, Poor Man" which you can read on the home page of my web site. If you start early enough (the earlier the better) and compound safe, dividend-paying stocks and top-grade bonds and continue to compound the dividends and interest that they throw off, you should at worst end up a satisfied investor and at best a rich investor.

The second method is based on Dow Theory. This method is as follows — you buy stocks early in a bull market and sell them late in the bull market. You switch to bills, notes and bonds in the bear market that follows, and you stay with these items until the bear market hits bottom. Personally, I combine both systems. But I'm afraid that the percentage of investors who follow either system is rather small. The problem — they're steered off the path by the "music" that I've described above. They're thrown off course (assuming they were ever on course) by the news of the day, by Wall Street's forecasts, by greed, by impatience, by ignorance and by lacking any sort of a strategy. Right now, according to my studies, we have a bear market in stocks which has moved into its second psychological phase. And we have a bull market in gold, which is still in its first psychological phase.

INVESTMENT POSITION – The sirens of the market are now doing everything they know how to do – to lure investors back into the market. The best way to do this is to set off a secondary (upward) correction, a correction that looks good enough to be the "real deal."

Trading bear market rallies is a difficult procedure. A lot of investors try and many succeed – for a while. But in my experience, the practice of trading secondary corrections in a bear market tends to be a loser. I've known hundreds of subscribers who have tried. Few end up doing well. It's just too difficult, too tricky, and too tough on the nerves.

In my experience, the most difficult thing to do is to buy early in a bull market and to remain in that bull market until near the final, highly speculative top. By the same token, the most difficult thing to do is to sell out near the beginning of a bear market, and then to stay out of the bear market until great values appear again.

How do you measure great values? I believe the best test, the classic test, is via the dividend yield. But today a huge number of stocks don't pay dividends. My answer is – **they will**. As this bear market moves along, the pressure to pay dividends will increase. People will complain, "The only thing worse than holding stocks in a bear market is holding stocks that pay no dividends in a bear market."

According to classic capital market theory, a stock's price should represent the discounted net present value of all future cash streams. Note not the discounted net present value of all future earnings, but all future dividends. After all, if I hold a stock for 15 years, and that stock generates steady earnings, what good are all those earnings to me if the stock never pays me a dividend?

Thus, I believe before this bear market is over, we'll see dividends coming to the fore again. At the year 2000 high the S&P was selling at 94 times its dividends. Right now the S&P is selling at 55 times dividends. When this bear market hits bottom, I expect the S&P to sell at 14 or less times dividends. That's when we know that the bear market is close to, or about over.

LATE NOTES – Most of what I read in the newspapers, magazines and advisories are fairly "pat" at this time. "Yeah, admittedly, this is a bear market, but probably the worst has been seen. At the July lows the market discounted most of the bad news, and the nation should gradually recover from here."

The accent continues to be on what stocks to buy, what segment of the market one should be in – anything but a very defensive position and a portfolio with few if any stocks represented.What most of the analysts, even the bearish ones, forget is that in primary bear markets a chain of circumstances is set off. It's much like a set of invisible dominoes falling. Bad things happen in bear markets, and I mean unexpected, often unintended bad things.

I've likened a bear market to the beach when the tide rolls out. As the water recedes, we see all the broken shells, the dead fish, the bits of rotting garbage in the sand. When the tide goes out, all the nasty items that the water covered are exposed for us to see.This is the reason why it pays to be so careful in a bear market. It's the unexpected, it's the hidden frauds, disasters and lies that come to the surface that can prove so dangerous. Let me give you Russell's bear market rule – In a primary bear market whatever can go wrong, will go wrong." And that can even include the wrong people in Washington and the White House taking control.

Next Mailing: September 11, 2002